Article from:

# News Direct

January 2005 – Issue 49

# PRENEED INSURANCE

*BY ERIC BROEDEL*

Nontraditionally marketed products often are thought of as being direct-marketed, e-marketed or bank-marketed (to name a few channels). It is easy to forget, sometimes, that preneed products fall under the NTM umbrella as well. As it is not something encountered in every company, perhaps the preneed market deserves a bit of introduction. But what is preneed insurance? To help understand this lesser known nontraditionally-marketed form of insurance, let's look at the following example.

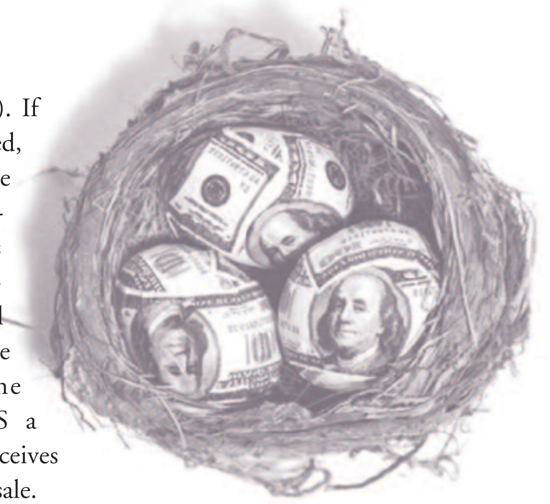
## What is Preneed Insurance?

Because he either knows he's ill or he simply doesn't want to burden his loved ones when the inevitable happens, Joe goes to his local funeral home to prearrange his funeral. He selects the goods and services with the help of his funeral director (casket, plot, ceremony, etc.). He either pays for this up front or in installments. The funeral director often guarantees that when Joe dies, he will get everything he selected, regardless of what actual costs are at the time of death. Even if he doesn't guarantee the funeral, the funeral director would like to be able to fulfill Joe's wishes since the alternatives are: (a) go back to a grieving family and ask for more money, or (b) offer an inferior package, or (c) eat the cost difference. The goods and services and delivery thereof are spelled out in a preneed contact between Joe and the funeral home.

It is important then for the funeral director to find a way to be sure that Joe's actual payments are sufficient to cover the actual costs at the time of death (i.e., he needs an inflation hedge).

There are two main ways he does this: (a) put Joe's payments into a trust and hope it grows sufficiently, or (b) use Joe's payments to buy a preneed insurance policy.

One of the main reasons that trusts are used is that funeral directors don't want to deal with the requirements to be a licensed life insurance agent (e.g. continuing education). If a preneed policy is used, then mechanically Joe purchases the insurance policy and does an irrevocable assignment to the funeral home. Under these circumstances, the funeral director IS a licensed agent and receives a commission for the sale.



This is different from final expense, which is often confused with preneed. Final expense is a small level face amount policy sold by an agent to a policyholder, so there will be funds available to cover final expense at death. There is no underlying preneed contract; the beneficiary can use the death benefit for whatever he chooses.

## Typical Product Features

The typical preneed insurance product is a limited-pay traditional whole life product with increasing death benefits. Specific features are discussed below.

### 1. Underwriting

The product is usually available on a pure guaranteed issue or a simplified issue basis. The guaranteed issue version asks no health questions, while the simplified issue version only asks three to five questions designed to weed out the near term deaths. Typical questions cover recent heart, kidney or liver problems, cancer, Parkinson's or ALS.

### 2. Average Size

Average size is around $5,000. The funeral director typically has two options (1) use all of Joe's payments (which equates to his current funeral cost) and buy a policy with an initial face amount a little higher than the current cost, or (2) charge Joe a little less than actual cost and buy a policy with an initial face amount equal to current cost.

### 3. Premiums

About 60-70 percent of sales are single pay. Three, five, seven and 10 pay are also used, although some

| CONTINUED ON PAGE 22 |

*Eric Broedel is an associate actuary with Milliman in Chicago, Ill. He can be reached at (312) 726-0677 or at eric.broedel@milliman.com.*

| PRENEED INSURANCE … CONTINUED FROM PAGE 21 |

companies only offer multi-pay on a simplified issue basis.

Anything longer than a 10 pay is very rare. Premiums are almost always unisex. Single premiums are nearly equal to the underlying face amount and total premiums paid may actually exceed face amount for multi-pay plans.

**December tends to have a low incidence [of deaths] followed by a spike in January… many imminent deaths tend to hang on for Christmas and one last family get-together or to see the start of one more year.**

### 4. Death Benefits

Death benefits are the initial face amount increasing over time with inflationary increases. These increases can be guaranteed but are normally discretionary. Even if increases are discretionary, companies try to credit enough to keep up with inflation. Once an increase is given, it cannot be taken back. A few states mandate that these increases be guaranteed and linked to an index (e.g. Michigan-Detroit CPI). Most companies include a limited death benefit in the first couple of years on guaranteed issue sales. Normal limits are a return of premium for at least six months, increasing to full face over time. Limits are in place for at least one year for a three-pay plan, and two to five years for longer pay periods.

### 5. Commissions

Commissions are almost always paid at issue as a percentage of face amounts, although there are some companies that pay as premiums are received. They are almost always charged back on first-year terminations.

## Critical Assumptions

The most critical assumption, as one would guess, is mortality. This business, once written, is not interest-sensitive, since the underlying policyholder has already purchased his funeral and has no incentive to surrender his policy. The interest-sensitive part of this business is new sales. It's a very competitive market so if discretionary growth rates drop below competition, sales may go elsewhere.

Mortality varies dramatically between guaranteed issue and simplified underwritten business. Underwritten business comes in around 75-80 percent of census mortality (e.g., the U.S. Life Tables) grading to 100 percent over five to 10 years. On the other hand, single-pay guaranteed issue averages about 300-400 percent in the first year, grading to 100 percent over five to 10 years. Multi-pay guaranteed issue is even worse and can range as high as 800-1,000 percent or even higher in the first year. That's why the limited death benefits are a crucial part of the product design in the early years.

You also will see first year deaths on guaranteed issue business heavily skewed to the first few months. As much as 60 to 70 percent of total first year deaths can occur in the first five to six months. Finally, there's also a seasonality factor. Winter months typically have more deaths. One interesting trend is that December tends to have a low incidence followed by a spike in January. As you probably could guess, many imminent deaths tend to hang on for Christmas and one last family get-together or to see the start of one more year.

## Evaluating Profitability

The best way to analyze results is to view this product from a source of earnings perspective. Statutory profit is defined by the following:

Interest Margin
+ Mortality margin
+ Surrender margin
+ Expense margin
– FIT
– Cost of capital
= Statutory gain

Each of these is discussed below.

### 1. Interest Margin

This is equal to the difference between investment income on assets supporting reserves and the combination of tabular (valuation) interest on reserves and the inflationary credits given to total death benefits. A typical product will actually have a negative gain such as the following:

6.0 percent investment earning rate
– 4.5 percent valuation rate
– 2.5 percent death benefit growth
= (1.0) percent

For products where the death benefit growth is guaranteed and reflected in the projected benefits used to calculate statutory reserves, the death benefit growth term above would be excluded and a positive gain would result.

It is also worth noting that while it is customary to view it this way, the actual gain is even lower since death benefit growth is applied to death benefit and not to reserves. Reserve levels are typically about 70 percent of death benefit.

### 2. Mortality Margin

This is defined as the difference between tabular (valuation) mortality and experience mortality.

For guaranteed issue business, it is negative in the first few years, then slightly positive thereafter. For underwritten business, it is slightly positive in all years.

Although it is not common, some companies, use a substandard valuation mortality on guaranteed issue plans, recognizing that actual early year experience mortality is far worse than standard valuation tables.

### 3. Surrender Margin

This is defined as the difference between cash value paid on surrender and reserve released. For the typical product, this is a zero gain/loss in all years.

Since surrenders are usually not an issue with this business, it is common to set cash value equal to reserve, both for administrative ease as well as for tax efficiency as discussed in the FIT section below.

For indexed business where Actuarial Guideline XXV requires prefunding some future death benefit increases, the cash value will not prefund due to Section 7702, and there will be a gain on surrender.

### 4. Expense Margin

This is THE source of earnings for preneed products. It is defined as the difference between gross premiums charged and the sum of (a) tabular (valuation) net premiums in the underlying reserves and (b) expenses incurred. It is typically 30 percent of single premiums and 40-70 percent of multi-pay premiums.

### 5. Federal Income Tax

Normal FIT (excluding DAC tax) is typically a company's effective tax rate time pretax earnings. This is because by setting cash values equal to statutory reserves (as mentioned above), it follows that tax reserves will also equal statutory reserves.

For products with cash values that are lower than statutory reserves, the tax reserves will also be lower than the statutory reserves, creating a tax inefficiency.

Since this business is limited pay with a high proportion of single-pay business, premiums are large and there is a significant DAC tax impact. One mitigating factor is that a lot of preneed is sold on a group form so that the lower 2.05 percent capitalization rate applies.

### 6. Cost of Capital

If using an RBC approach to required capital, the product generates a large initial cost (because of the C-4 factor applied to the high premiums), which is then released rather quickly. The C-2 component is small since reserves are high and thus net amounts at risk are low.

### 7. Statutory Gain

Statutory gain, then, is the net of the above margins. It's worth noting the various earnings patterns for single pay / multi-pay / discretionary growth / guaranteed (indexed) growth products. The typical pretax patterns are briefly described below.

*(A) Discretionary Growth / Single Pay*

This scenario is characterized by a large gain in the first year (heavy load) followed by losses thereafter (interest margin).

| CONTINUED ON PAGE 24 |

*(B) Discretionary Growth / Multi-Pay*

In this situation there is usually a first year loss, followed by gains through the remaining premium paying years, followed by losses thereafter. The first year loss is caused by the large commission paid wholly at issue. The subsequent gains are from premium loading with the losses thereafter from the interest margin.

*(C) Guaranteed (Indexed) Growth*

The patterns are similar to those for discretionary growth except for (a) a large first-year hit due to prefunding in the reserve, and (b) the interest margin losses are replaced by interest gains.

You should also note that all of this discussion is based on the current investment environment. When these products were first introduced, net earnings rates were 7-8 percent or higher, so the interest margin was positive. Unfortunately, this market can't make the needed drop to death benefit growth rates to keep pace with falling investment rates. Similarly, because of the history and competitiveness of this market, it's equally difficult to alter commission levels or to spread them instead of paying them up front.

What does all this mean? Very slim profit margins.

Typical margins (PV profit as a percentage of funeral value sold) after-tax and cost of capital are 1 percent or less on single pay and 3-5 percent on multi-pay. This also can vary significantly by issue age.

Even though overall margins from issue may be positive, the earnings pattern can be a cause for concern. As the earnings patterns described above suggest, when you look at a block of business, the "future profits" decrease significantly and even turn negative as the block ages. Profits are generally made during the premium period with losses thereafter.

## Summary

This is a brief overview of preneed insurance and its pricing. It touches on the high points, providing a flavor for the market. For those unfamiliar with preneed business, hopefully this article suffices as an introduction to this lesser known, nontraditionally marketed product.